THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 41 No. 4 April 2025

YOU'VE GOT TO FIGHT! FOR A CONTRACTUAL DIP FINANCING PARTICIPATION RIGHT

While many loan agreements contain a "sacred right" prohibiting "Required Lenders" from effectuating new money priming financing and/or the exchange of existing loans into such priming debt on a non-pro rata basis (commonly referred to as "Serta" protection), such Serta protection often contains a carve-out for debtor-in-possession financing. This article argues that lenders (both in syndicated and private credit facilities) should fight back against such a carve-out and expressly require as a sacred right a DIP financing participation right as part of "Serta" protection (or otherwise negotiate for a contractual DIP financing participation right) to protect against the value destruction attendant in a chapter 11 case where minority lenders are not offered the right to ratably participate in DIP financing commitments arranged and provided by the majority "Required Lenders." Such protection is especially important given the lack of protections for minority lenders under relevant bankruptcy law related to DIP financing.

By Michael R. Handler *

Countless ink has been spilled writing about how to mitigate the risk of value leakage for senior secured lenders and bondholders in connection with liability management exercises ("LMEs") and other financing structures pursued by financially stressed companies. Yet, one of the biggest risks of value leakage for senior secured lenders and bondholders in a downside scenario is not having the opportunity to participate in such lender's or bondholder's pro rata share of debtor-in-possession ("DIP") financing funded by an incumbent group of lenders or bondholders constituting the "Required Lenders" or "Majority Noteholders" (herein referred to as "Controlling Creditors") in the borrower's chapter 11 case. In sum, DIP financing can be used to effectively distribute substantially all of a minority lender's and/or bondholder's (hereinafter referred to as a "Minority Creditor") interest in collateral and enterprise value (and expected recovery) at the beginning of the chapter 11 case, and the Bankruptcy Code provides limited protections in connection therewith.

While a Minority Creditor excluded from pro rata participation in a priming DIP financing may be able to litigate its way to a participation right or change the terms of the DIP financing so that it isn't as dilutive, the limited case law on this issue — including the U.S. Bankruptcy Court for the District of Delaware's recent decision in the *American Tire Distributor's* chapter 11 cases — underscores the challenges of such litigation being successful. The *American Tire Distributor* decision and other bankruptcy case law, however, suggest that bankruptcy courts will enforce — or at least

* *MICHAEL R. HANDLER is a partner at King & Spalding LLP's New York City office. His e-mail address is mhandler@kslaw.com.*